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CITY OF SAN DIEGO

SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF SAN DIEGO

CITY OF SAN DIEGO, a municipal
corporation,

Plaintiff,

vs.

VINSON & ELKINS, L.L.P., an entity of
unknown qualification, and DOES 1 through
25, inclusive,

Defendants.

) Case No.:

) **COMPLAINT FOR**

) **(1) BREACH OF CONTRACT**

) **(2) BREACH OF FIDUCIARY**

) **DUTIES; AND**

) **(3) PROFESSIONAL NEGLIGENCE**

) **EXEMPT FROM FILING FEES**

) **PURSUANT TO GOVERNMENT CODE**

) **SECTION 6103**

) **(GENERAL CIVIL CASE – DAMAGES**

) **EXCEED \$25,000)**

) **Jury Trial Requested**

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1 Plaintiff, CITY OF SAN DIEGO (“the City”), alleges through its counsel of record as
2 follows:

3 **I.**

4 **OVERVIEW**

5 1. The City of San Diego is in the throes of one of the most daunting political and
6 financial crises in its history. The City is currently facing a pension funding deficit of between
7 \$1.4 billion and \$2 billion in its pension system, the San Diego City Employees’ Retirement
8 System (SDCERS). The City hired a law firm, Vinson & Elkins, L.L.P. (“V&E”), to defend it
9 before two agencies that were (and still are) investigating the crisis. The backbone of V&E’s
10 defense strategy was to prepare a report that it would offer to the investigators, which V&E
11 claimed, if not *warned*, would be an “objective ‘warts and all’ report” of the City’s behavior.

12 2. Once it had the City’s contract, V&E charged the City more than *forty times* what
13 it estimated it would take to do its work. When it was done, its work product was not as
14 promised—an “objective ‘warts and all’ report”—and was promptly dismissed by the SEC and
15 others as advocacy, or worse, a “white wash.” Like the work it did for one of its other prominent
16 clients, Enron, V&E’s investigation could best be described as having been performed with
17 “Eyes Wide Shut.”¹

18 **II.**

19 **VENUE AND JURISDICTION**

20 3. Venue is proper in this Court because the events and injuries complained of in this
21 Complaint occurred in the City and County of San Diego.

22 4. The amount in controversy under this Complaint exceeds the minimal
23 jurisdictional limit of this Court, and the claims asserted in this Complaint are within the subject-
24 matter jurisdiction of this Court.

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27 _____
28 ¹ Exhibit 1 (January 28, 2002 article by Dan Ackman entitled “Enron’s Lawyers: Eyes Wide Shut?” published in Forbes).

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III.

FACTS COMMON TO ALL CAUSES OF ACTION

5. In January 2003, Houston-based law firm V&E was one of three firms that responded to a Request for Proposal to review the City's newly created investor-information web page for conformance with securities regulations and industry guidelines. The web page was designed to provide publicly accessible investor information including the continuing disclosure of annual reports and related information. Based on the firm's specialized experience and bid to perform the services for the fixed fee of \$30,000, the City awarded the contract to V&E.²

A. The Pension Disclosure Problems Are Revealed

6. In September 2003, Diann Shipione, a SDCERS volunteer trustee, was the first to discover errors in the disclosure of pension-related information in a proposed City sewer bond offering. Shipione's discovery inspired a team of professionals to uncover and disclose significant errors in the City's 2002 Comprehensive Annual Financial Report ("CAFR") and in other disclosures.

7. While this process was unfolding, in December 2003, the City amended its original contract with V&E to account for additional consultation and legal services relating to the web site and "other disclosure related issues as-needed for a period of two years" at a cost of no more than \$27,000.³

8. The next month, on January 27, 2004, the City was forced to file with the nationally recognized rating agencies extensive corrections to its previously released financial disclosures.⁴ Those Voluntary Disclosures raised concerns with the U.S. Securities and Exchange Commission ("SEC") and the U.S. Attorney's Office ("U.S. Attorney"). Both federal agencies promptly launched investigations of the City in February 2004.

² Exhibit 2 (January 24, 2003, Request for City Manager Action, Agreement for Electronic Disclosure Counsel Services; and Auditor's Certificate number 2300856).

³ Exhibit 3 (December 9, 2003, Request for City Manager Action; First Amendment to Agreement for Electronic Disclosure Counsel Services; and Auditor's Certificate number 2400703).

⁴ Exhibit 4 (Municipal Secondary Market Disclosure).

1 **B. V&E Gives The City Advice About The Disclosue Problems Before It Began**
2 **Its Investigation**

3 9. During 2003, but before it was hired to perform its investigation, V&E
4 interviewed key City employees with knowledge of the pension system and the funding shortfall,
5 and strategized with the involved City employees, some of whom would later be indicted, about
6 what corrective efforts were or were not appropriate.⁵ As will be explained below, months
7 *before* the City hired it to assess the situation, V&E had already formed important opinions about
8 the appropriateness of the City’s response to the discoveries⁶ and who had caused the problems
9 in the first place.⁷

10 **C. The City Authorizes \$150,000 For V&E To Investigate The Disclosure**
11 **Problems And To Prepare A Report That Would “Not Be An Advocacy**
12 **Document,” But Would Be An “Objective ‘Warts And All’ Report”**

13 10. In January, 2004, the City recognized that it “need[ed] outside legal expertise to
14 assist in performing a review of current and past financial disclosure practices, and in responding
15 to an inquiry by the Securities and Exchange Commission.”⁸

16 11. The City turned to V&E for this expertise and appropriated \$150,000 for the
17 review and SEC defense.⁹

18 12. On February 18, 2004, having already formed important opinions about the
19 matter, V&E offered in writing to be hired to defend the City in the SEC and U.S. Attorney
20 investigations. V&E prepared an Engagement Letter,¹⁰ a binding contract, which the City
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22 _____
23 ⁵ Exhibit 5 (November 26, 2003, Notes of Terri Webster). Certain of the exhibits to this
24 pleading, including Exhibit 5, contain other designations (e.g., Bates Codes). The exhibit
25 numbers in this pleading will always refer to the tabs or slip sheet designations.

26 ⁶ Exhibit 5 (“Paul M[aco of V&E] can see how Paul W[ebber of Orrick, Herrington & Sutcliffe,
27 outside disclosure counsel] could find these errors material”).

28 ⁷ Exhibit 5 (Paul Maco of V&E quoted as saying to Webster, “lack of solid processes on City
and CJO that didn’t catch this stuff”).

⁸ Exhibit 6 (January 22, 2004, Request for City Manager Action, Retention of Vinson & Elkins,
As Outside Counsel, In Connection with the City of San Diego Financial Disclosures; and
Auditor’s Certificate number 2400800).

⁹ Exhibit 6.

¹⁰ Exhibit 6.

signed. In the V&E-drafted Engagement Letter, V&E offered and promised to:

- perform an investigation with an “initial scope” that “will be agreed upon by separate cover;” and
- prepare a Report that would “not be an advocacy document,” but would, according to V&E, be an “objective ‘warts and all’ report.”

13. As explained below, V&E breached these promises.

D. KPMG Regularly Advises V&E What Is Needed—And Expected

14. V&E did not deliver the promised “initial scope” for its investigation that “w[ould] be agreed upon by separate cover.” Rather, it promptly went to work, and began billing the City, with the Engagement Letter as its only agreement and only written directive. Its first bill, after a month’s work, was \$149,987.22, just \$12.78 less than the *full* contract amount.

15. Two months later, in April 2003, the City engaged KPMG LLP to re-audit the City’s 2003 financial statements.¹¹ KPMG explicitly cautioned the City that it would not finish its audit report until V&E completed its investigation and Report.¹² Now, KPMG was also waiting for V&E’s promised “objective ‘warts and all’ report.”

16. KPMG thereafter was in regular and direct contact with the City, which in turn was in regular and direct contact with V&E, each making sure that V&E did not misunderstand what *exactly* it needed to do.

17. Within a month however, KPMG officials began to voice concerns to City officials that V&E’s investigation may not be addressing the necessary issues. The City passed on to V&E KPMG’s concerns so that V&E could not misunderstand what was expected of it.

18. By August, 2004, KPMG’s concerns regarding V&E had risen to the level that KPMG wrote the City to make sure V&E addressed the right issues:

To date, we have had several discussions with Paul Maco of Vinson & Elkins (V&E) and have read the material provided by V&E with reference to their investigation and the formal inquiry and investigation being conducted by the Securities and Exchange Commission (SEC), the Department of Justice and US Attorney

¹¹ Another auditing firm, Caporicci & Larson, had already completed an audit for fiscal year 2003. Because of all of the negative developments beginning in September 2003, the City hired KPMG to, in effect, re-do the 2003 audit.

¹² Exhibit 7 (April 13, 2004 letter from KPMG Partner Steven DeVetter to Lisa Irvine, director of the City’s Financial Management Department).

[sic] Office. Based on these discussions and our reading of the documents provided, we understand the following:

1. In September 2003, Ms. Diann Shipione, a San Diego City Employees' Retirement System (SDCERS) Board Member and Trustee, notified city officials and underwriters of errors and omissions in the City's financial statements dating back to 1996 and asserted the errors falsely improved the City's financial condition and were done intentionally to misstate and hide the real condition of the pension system.

2. Subsequent to the notification by Ms. Shipione, the City retracted the Preliminary Official Statement relating to a \$505 million bond offering, filed a voluntary disclosure statement with the SEC acknowledging errors and omissions and engaged V&E to investigate and issue a report on the disclosure practices of the City.

3. The city has sold more than \$2.3 billion in municipal bonds using financial statements believed to contain certain errors or omissions.

4. Ms. Shipione has alleged in various communications with the City Council, Mayor and other top city officials, that the steps taken to deliberately underfund the plan are illegal, violate the City Charter, and are at odds with statutes and court cases of the State of California.

5. Ms. Shipione has alleged that the decision to allow the underfunding was reached through a corrupt process in which the required funding was deferred to garner benefits for current employees.

6. On June 11, 2004, the City reached a tentative settlement on the Gleason lawsuit. The Gleason lawsuit alleged that the underfunding of the pension plan was illegal and violated the City Charter, Municipal Code and California Constitution and that the SDCERS Board breached their fiduciary duties by allowing the City to underfund the plan. The settlement was reached without resolving the legal questions raised.

7. The SEC launched a formal inquiry in February 2004 under the anti-fraud provisions of section 17(a) 2&3 of the Securities Act of 1933 with reference the City's previous bond offerings. As part of that inquiry, we understand that the SEC may be considering allegations made in the press, and in particular allegations made by Ms. Shipione.

8. An e-mail provided to the SEC appears to indicate the SDCERS actuary may have worked with the City to change assumptions with the intent of lowering the calculated actuarial required contribution by the City.

AICPA Professional Standards state in section AU 317:

1 10. When the auditor becomes aware of information concerning a
2 possible illegal act, the auditor should obtain an understanding of
3 the nature of the act, the circumstances in which it occurred, and
4 sufficient other information to evaluate the effect on the financial
5 statements. In doing so, the auditor should inquire of management
6 at a level above those involved, if possible. If management does
7 not provide satisfactory information that there has been no illegal
8 act, the auditor should—

9 a. Consult with the client's legal counsel or other specialists
10 about the application of relevant laws and regulations to the
11 circumstances and the possible effects on the financial statements.
12 Arrangements for such consultation with client's legal counsel
13 should be made by the client.

14 b. Apply additional procedures, if necessary, to obtain further
15 understanding of the nature of the acts.

16 As indicated in our engagement letter dated April 13, 2004, we
17 will not issue our auditors' report until a determination is made
18 that the investigation being conducted by V&E is sufficient and
19 complete. We acknowledge V&E's effort and cooperation in
20 explaining the process they are undertaking to KPMG.

21 Based on discussions with you, V&E, and the reading of the
22 documents provided and, consistent with our previous
23 conversations, we are providing you the following observations
24 regarding our understanding of the scope of the investigation to
25 help avoid surprises once we review the draft report.

26 **We believe the investigation being conducted by V&E should
27 address and resolve the following questions:**

28 1. Whether or not the financial statements and or the disclosures in
the financial statements were intentionally misleading and, if yes,
what individuals were involved and what, if any, remedial action is
recommended?

2. Did the City enter into any agreement, including the "Managers
Two" agreement, or otherwise take any actions that resulted in the
underfunding or misuse of pension funds that is a violation of
State, City or other laws?

3. Did the SDCERS Board breach their fiduciary duty by allowing
the City to underfund the plan in exchange for additional benefits
for current employees and could this action have been in violation
of any laws?

4. Is the use of surplus earnings to pay city obligations such as
benefits outside of the plan illegal?

5. Did the City violate the City Charter by failing to fund its
retirement plan as required by the City Charter?

1 6. Did the SDCERS Board and/or the City violate the California
2 Constitution by allowing the City to intentionally underfund the
plan?

3 7. Was undue influence placed on the actuary to change
4 assumptions to reduce the shortfall of the City's contribution
5 compared to the ARC, and, if yes, at whose direction and what
action does the City plan to take to rectify this action, if
applicable? (Emphasis added.)¹³

6 19. KPMG included with its letter a copy of the American Institute of Certified Public
7 Accountants AU section 317.¹⁴

8 20. V&E knew of KPMG's letter at the time it was sent, knew of KPMG's concerns
9 (because KPMG had made its concerns known to V&E directly in a meeting conducted on
10 August 27), and knew that a report that failed to address KPMG's concerns was of little or no
11 help to KPMG, and, therefore, the City.

12 21. Less than a month later, on September 1, KPMG again warned the City (and,
13 through the City, V&E):

14 [W]e think it is fair to say that over [the last few months] we have
15 expressed our concerns about the scope of the investigation as it
16 has been described by us [W]e remain concerned that the
scope of the investigation may not be sufficient to enable us to
conclude that the City has adequately addressed certain issues
pertinent to our audits

17 [W]ithout in any way prejudging what our reaction to the final
18 report will be, you should be aware that, if following our review of
19 the V&E report we conclude that the V&E report is not sufficient
20 to resolve all of the issues we face in the audit, we may advise you
that additional investigative procedures may be necessary before
KPMG can complete its work.

21 22. The City made known to V&E of KPMG's concerns. As an example, on
22 September 8, 2004, City Manager Lamont Ewell sent out a press release that stated in part:

23 The Vinson & Elkins report has not yet been completed, but the
24 city expects it to be completed within the next few weeks. Once
KPMG receives the Vinson & Elkins report, it is the City's
25 expectation that it will take KPMG at least a few weeks to digest
the report and its findings in order to complete its audit.

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27 ¹³ Exhibit 8 (August 9, 2004 letter from KPMG Partner Steven DeVetter to Leslie J. Girard,
Assistant City Attorney).

28 ¹⁴ Exhibit 9 (American Institute of Certified Public Accountants AU § 317. Illegal Acts by
Clients).

1 **E. V&E’s Serial Budget Increases**

2 23. In April 2004, the City Council appropriated an additional \$350,000 to complete
3 the report” and for continued representation before the SEC.¹⁵

4 24. In May 2004, the City Council appropriated an additional \$800,000 for V&E’s
5 services. Of that amount \$500,000 was to pay again for V&E “to complete the report” and
6 \$300,000 more to pay for representation of the City and a production of its documents before the
7 SEC and U.S. Attorney’s Office. The total cost of legal services was not to exceed \$1.3
8 million.¹⁶

9 25. By the end of August 2004, V&E still had not completed the internal report.
10 Therefore, on August 24, 2004, the City Council appropriated an additional \$700,000 for its
11 services. The total cost of legal services was not to exceed \$2.0 million.¹⁷

12 **F. V&E’s Report**

13 26. On September 16, 2004, V&E issued its report titled “Report on Investigation:
14 The City of San Diego, California’s Disclosures of Obligation to Fund the San Diego City
15 Employees’ Retirement System and Related Disclosure Practices” (“the Report”).¹⁸

16 27. The Report outlined two different agreements between the City Council and the
17 SDCERS Board of Administrations (“Board”) as the primary sources of the pension deficit. The
18 first deal, commonly referred to as Manager’s Proposal I, was approved in 1996. The second
19 deal, called Manager’s Proposal II, was approved in 2002. The Report found that a series of
20 disclosure violations occurred.

21 28. The Report, however, made no mention of any individual violations of law by
22 City or SDCERS officials. In fact, notwithstanding its promise for an “objective ‘warts and all’

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24 ¹⁵ Exhibit 10 (April 12, 2004, Resolution number 299077, adopted on April 12, 2004; Request for
Council Action dated; Auditor’s Certificate number 2400977).

25 ¹⁶ Exhibit 11 (June 7, 2004, Resolution number 299313; Request for Council Action dated May
27, 2004; Auditor’s Certificate number 2401131).

26 ¹⁷ Exhibit 12 (September 27, 2004 Resolution number 299693; Request for Council Action dated
August 24, 2004; Auditor’s Certificate number 2500255).

27 ¹⁸ Exhibit 13 (September 16, 2004. V&E: Report on Investigations. The City of San Diego,
California’s Disclosures of Obligations to Fund the San Diego City Employees’ Retirement
28 System and Related Disclosure Practices 1996-2004 with Recommended Procedures and
Changes to the Municipal Code).

report,” V&E made no assessment of potentially illegal acts by anyone, within or outside the City.

29. Based on a scope of investigation that had never been defined (a breach by V&E), V&E found (1) “no evidence of affirmative deception,” (2) those “individuals responsible for the City’s disclosure lacked both motive and opportunity to mislead,”¹⁹ (3) “no evidence that any City employees were personally enriched as a result of the disclosure decisions in which they participated,”²⁰ and, (4) that it was “difficult to attribute the City’s failure to fully and accurately describe [this] matter to intentional misconduct on the part of individualized employees.”²¹

30. Thus, just as with another client paying it millions of dollars—Enron—V&E found “no evidence” of intentional misconduct by its client, the City.²²

G. KPMG Rejects The Report’s Approach And Conclusions

31. Not surprisingly, KPMG was unsatisfied with the Report. On October 11, 2004, KPMG wrote that the Report was insufficient to meet professional auditing standards:

[W]e do not believe that the City of San Diego (“City”) has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred, or that appropriate remedial action has been taken. Such an investigation is necessary in order for an auditor to complete an audit in accordance with generally accepted auditing standards and *Government Auditing Standards*.²³

¹⁹ Exhibit 13 at p. 7.

²⁰ Exhibit 13 at p. 6.

²¹ Exhibit 14 at p. 159.

²² V&E’s work analyzing Enron’s accounting irregularities was referred to as

- “**a whitewash.**” Exhibit 14 (January 15, 2002 article entitled “Enron Employee Told Lay Last Summer Of Concerns About Accounting Practices” by Michael Schroeder and John Emshwiller, published in the Wall Street Journal) (House Energy and Commerce Committee spokesman Ken Johnson referring to Enron inquiry as “ha[ving] the appearance of a whitewash.”);
- “**a cover-up,**” Exhibit 15 (March 15, 2002 article entitled “Law Firm’s Attorneys Criticized at Hearing” by Carrie Johnson, published in the Washington Post.) (“Another [Congressman] bluntly asked, ‘in what way would a cover-up look different’ than the report the firm [V&E] prepared regarding allegations about accounting irregularities at Enron?”); and
- comparable to the work of **Inspector Clouseau**. *Id.* (One lawmaker compared the work of Vinson & Elkins, Enron Corp.’s outside law firm, to that of Inspector Clouseau, the bumbling detective character in the ‘Pink Panther’ movies.”).

²³ Exhibit 16 (October 11, 2004, Letter from Steven G. DeVetter to Leslie J. Girard. Re: City of San Diego Fiscal Year 2003 Audit).

1 32. V&E responded to Assistant City Attorney Leslie Girard on October 28, 2004,
2 stating that KPMG “fail[ed] to provide any practical guidance as to what additional investigative
3 procedures [KPMG] would find satisfactory” for the completion of the Report.²⁴

4 33. KPMG reasserted the need for an illegal acts investigation in an October 29, 2004
5 letter to former Mayor Dick Murphy. In the letter, KPMG commented explicitly on V&E’s
6 “oppositional tone,” and, worse, its “V&E’s willingness or ability in these circumstances to
7 complete the investigation”:

8 If the City is prepared to proceed with an appropriate
9 investigation, then we urge you to consider retaining counsel other
10 than V&E to do so. The positions asserted in, and oppositional
11 tone of, Mr. Maco’s letter raises questions about V&E’s
12 willingness or ability in these circumstances to complete the
13 investigation of, and reach conclusion on, the audit-critical
14 questions posed in our prior oral and written communications and
15 to do so with an objective and independent manner.²⁵

16 34. Aware of KPMG’s concerns, V&E nevertheless agreed to complete the
17 investigation and to provide its analysis in a second report. To this end, in October 2004, the
18 City again commissioned V&E to perform additional investigation into allegations of allegedly
19 improper acts related to financial reporting. Such investigation was required in order to secure
20 the opinion from the City’s outside auditor, KPMG, for the Fiscal Year 2003 CAFR. The City
21 Manager approved an appropriation of \$250,000.

22 35. While the prior resolutions adopted by the City required the City Attorney to enter
23 into a contract with V&E, the Manager’s Action of October 2004 required the contract to be
24 managed by the City Manager’s office. Furthermore, V&E was to report directly to the Mayor
25 with respect to the results of the additional investigation.²⁶

26 36. In early November 2004, additional work was requested of V&E to facilitate the
27 completion of the audit of the City’s FY2003 basic financial statements. V&E was again

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²⁴ Exhibit 17 (October 28, 2004, Letter from V&E Partner Paul Maco to Assistant City Attorney Leslie Girard. Re: Additional Investigation).

²⁵ Exhibit 18 (October 29, 2004, Letter from KPMG Partner Steven DeVetter to Assistant City Attorney Leslie Girard. Re: Follow-up from meeting on August 27, 2004 (Exhibit 14)).

²⁶ Exhibit 19 (October 22, 2004, Request for City Manager Action; Retainer Agreement dated October 15, 2004; and Auditor’s Certificate number 2500413).

1 retained to perform additional investigation and to continue to provide representation of the City
2 before the SEC. An additional \$350,000 was appropriated for this purpose.²⁷

3 **H. The SEC Rejects The Report And V&E's Role**

4 37. By 2005, the City was advised that the SEC would not rely on the Report, and that
5 the SEC perceived V&E's representation of the City to be flawed. As later explained publicly by
6 Benito Romano, the former U.S. Attorney for the Southern District of New York and a partner
7 from Willkie Farr & Gallagher LLP ("Willkie Farr"), who later effectively took over V&E's role
8 with the SEC: "[T]he Vinson & Elkins report was not regarded as independent by the [SEC]
9 staff and therefore would not receive the same favorable consideration [as he expected Kroll's
10 report to receive]."

11 **I. The SEC's Rejection Of V&E's Efforts Leaves The City No Choice But To
12 Hire A Replacement for V&E**

13 38. The City Attorney subsequently released a series of Interim Reports outlining
14 alleged illegal acts that occurred in the approval of the Manager's Proposal I in 1996 and
15 Manager's Proposal II in 2002. The first Interim Report was issued on January 14, 2005 and the
16 second Interim Report was issued on February 9, 2005.²⁸

17 39. The City Council then hired Kroll, Inc., to sort out the findings of V&E and the
18 City Attorney. The Kroll scope of services were stated as follows:

19 The City has requested that Kroll (1) receive, review and evaluate
20 the findings of the investigations by VINSON & ELKINS and the
21 City Attorney. The City has also requested Kroll provide
22 consulting assistance in assessing internal control deficiencies
23 affecting matters discussed in the investigation reports.²⁹

24 40. As stated earlier, V&E agreed to prepare a second report after KPMG found the
25 Report to be insufficient. In March, 2005, V&E obtained an additional appropriation of \$1.2

26 ²⁷ Exhibit 20 (November 23, 2004, Resolution number 299880; November 8, 2004, Request for
27 Council Action; Auditor's Certificate number 2500496).

28 ²⁸ Exhibit 23 (February 9, 2005, Interim Report No. 2 Regarding Possible Abuse, Fraud, and
Illegal Acts by San Diego City Officials and Employees. Report of the San Diego City Attorney
Michael J. Aguirre).

²⁹ Exhibit 22 (February 10, 2005, Letter from Troy Dahlberg to Mayor Richard Murphy and San
Diego City Council. Re: Independent Services for the City of San Diego).

1 million from the Council to assist KPMG's investigation and to represent the City before the
2 SEC.³⁰ That appropriation was again increased (this time by \$1.8 million) in June.³¹

3 41. In July 2005, V&E issued a draft second report,³² submitted it to the
4 representatives of Kroll,³³ but did not release on the record to City Council or the City Attorney.
5 Rather, in response to a series of questions by the City Attorney and Council member Donna
6 Frye in August 2005, Kroll admitted the existence of a draft copy and turned it over to City
7 officials.³⁴

8 42. The second V&E report found that the City did not adhere to proper accounting
9 and financial disclosure practices in its CAFR.³⁵ However, it concluded that no individuals
10 knowingly violated any laws. The report was discounted by KPMG and was widely considered
11 to be another V&E "white wash."

12 43. The second report failed to meet the requirements of AU § 317, which was
13 explicitly required by KPMG in its earlier letters to the City. Neither of the investigative reports
14 by V&E included an analysis of the computer hard drives of City Council members and their
15 staffs, according to Paul Maco at the August 9, 2005 meeting of the City Council. This failure
16 was only part of the story of what V&E *didn't* review.

17 **J. The City Later Discovers A New Flaw In V&E's Efforts: It Analyzed Only A**
18 **Subset Of The Available Documents**

19 44. One of the tasks V&E performed was coordinating the City's document
20 production in response to SEC subpoenas.
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23 ³⁰ Exhibit 23 (March 1, 2005, Resolution number 299880; February 28, 2005, Request for
24 Council Action; Auditor's Certificate number 2500773).

25 ³¹ Exhibit 24 (June 27, 2005 Request for Council Action; Auditor's Certificate number
26 2501112).

27 ³² Exhibit 25 (July 15, 2005, V&E draft report titled "Potential Violations of the Federal
28 Securities Laws by the City of San Diego and Associated Individuals).

³³ Exhibit 26 (July 15, 2005, E-mail from Jennifer Arnini to Michael Young, Benito Romano,
and Brian Turetsky).

³⁴ Exhibit 27 (August 1, 2005 meeting minutes of the San Diego City Council).

³⁵ Exhibit 25.

1 45. In order to make the documents production more efficient, V&E had been using
2 an electronic discovery system product from NTI Breakwater for placement in a database, or
3 documents repository, maintained by Applied Discovery, a subsidiary of Lexis-Nexis.

4 46. The City e-mail system is run off of a program called GroupWise, made by the
5 Novell Inc. The hardware is proprietary and cannot be viewed on some computer programs.

6 47. V&E employed the NTI Breakwater product to convert the GroupWise
7 documents to a file that can be opened and viewed by other computer programs for KPMG and
8 federal investigators.³⁶ The files converted by NTI Breakwater were then placed in an electronic
9 depository, or database, operated by Applied Discovery. KPMG and federal investigators were
10 then given access to the Applied Discovery database where the documents were stored. In this
11 database, the documents could be opened and viewed.

12 48. As early as January 2005, officials at Applied Discovery, KPMG and V&E
13 realized that some of the attachments to documents were not being converted and placed into the
14 database. Specifically, if an email, or “parent,” had an attachment, or “child,” the parent would
15 appear in the Applied Discovery database but the child was missing. Kelli Clark, an account
16 manager at Applied Discovery, spotted the issue and forwarded the information in an e-mail:

17 I had our production team look into doc 206722 at KPMG’s
18 request. When our team looked at the pre-converted document, the
19 links to the attachments were ‘dead’. Hence, the attachments are
20 not extracted and linked to the e-mail on the ORA. Additionally,
 when we look at doc #125481 (the number of the attachment that
 you provided today) there is no evidence that this document is an
 attachment to any other doc in the system.³⁷

21 49. Investigators at the SEC had realized this to be an issue early on, according to an
22 e-mail sent from Ben Lippard, an attorney at V&E to Paul Maco. Lippard wrote:

23 [T]he SEC was concerned about the fact that from applied
24 discovery database you can’t tell which file attachments belong to
25 which emails. I have instructed [someone to find] a technical fix
 to this issue, which it seems likely they will insist on.³⁸

26 ³⁶ Exhibit 28 (November 22, 2004, City of San Diego consulting engagement agreement with
27 NTI Breakwater).

27 ³⁷ Exhibit 29 (January 10, 2005, E-mail from Kelli Clark to Ben Lippard).

28 ³⁸ Exhibit 30 (February 8, 2005, E-mail from Ben Lippard to Paul Maco. Carbon-copied to Rick
Sauer and William Lawler. Subject: Update on SEC call).

1 50. This was a problem because the SEC and KPMG had both repeatedly asserted the
2 need to see all documents requested to ensure that alleged improprieties that landed the City in
3 its current financial difficulties would not happen again. If some of the e-mails and other
4 electronic documents were not available, the investigation could not be completed.

5 51. The problem was solved by Applied Discovery and NTI Breakwater on 2 May
6 2005 and a solution was presented to KPMG and the SEC in May. Kelli Clark wrote, “Ok. FYI
7 – I just got word from our tech department that the family groups work is complete now.
8 Whenever you give the go ahead, we are ready to begin the transfer.”³⁹

9 52. City Manager Lamont Ewell released a memo on September 8, 2005, stating that
10 V&E had failed to review more than 57,000 files of the 160,000 relevant documents.⁴⁰ Ewell
11 wrote:

12 The failure to include these files on the database has delayed the
13 City’s production of documents to the SEC and the United States
14 Attorney’s office. In addition, this error has caused the City to
15 incur significant costs in having the missing files restored, and
costs associated with a complete review of mails required by the
Audit Committee, in addition to the attorneys’ fees and expenses
associated with creating and reviewing the original database.

16 It is my belief that V&E was responsible for providing instructions
17 to and supervising the work of ADI as part of its investigation and
report to the City on disclosure matters.⁴¹

18 53. On October 25, 2005, Kroll sent a letter to notify the City that the investigation
19 and report would not be completed until mid-March due to a series of new problems.⁴² The letter
20 also stated that numerous problems had arisen from a computer program that V&E had used to
21 catalogue documents in a database. As a result, Kroll and Willkie Farr would need to hire more
22 consultants to fix this problem and create a second electronic database to store documents.
23 Accordingly, Representatives of Kroll and Willkie Farr appeared before the City Council
24

25 ³⁹ Exhibit 31 (May 2, 2005, E-mail from Kelli Clark to Ben Lippard. Subject: RE: Transfer of
data to a new database for the SEC).

26 ⁴⁰ Exhibit 32 (September 8, 2005, letter from City Manager P. Lamont Ewell to Paul Maco,
partner for V&E).

27 ⁴¹ Exhibit 32.

28 ⁴² Exhibit 33 (October 25, 2005, Letter from Arthur Levitt, Lynn Turner, and Troy Dahlberg to
Acting Mayor Toni Atkins. Re: Audit Committee – Investigation Status Update).

meeting on November 1, 2005 and received additional funding for its work and for the work of consultants to analyze and build the new database.⁴³

K. The City Later Discovers Another Flaw In V&E’s Work: It Did Not Report The Failures Of Outside “Disclosure Counsel,” With Whom V&E Had Established A Bond Before It Even Began The Investigation

54. For twenty years or more, Orrick Herrington & Sutcliffe (“Orrick”) has served as the City’s outside bond and disclosure counsel on a multitude of municipal bond offerings. Orrick’s role has been the City’s most hired lawyer to lead municipal financing efforts and to serve as disclosure counsel regarding the sufficiency of the City’s disclosures.

55. During seven of those years, all of the City’s Official Statements contained a nearly identical pension disclosure in Appendix A. Under the heading “PENSION PLAN,” the text stated:

State legislation requires the City to contribute to [SD]CERS at rates determined by actuarial valuations.

56. V&E interviewed the Orrick’s lawyer responsible as “disclosure counsel” for multiple of the City’s bond offerings (Paul Webber). When V&E interviewed him, Webber was not able to identify the state legislation to which this sentence refers.

57. This failure is all the more egregious where, as here, the City’s CAFRs (which are a part of the materials Orrick reviewed and included in the bond offerings at issue) disclose that actuarial funding was *not* occurring. Thus, the bond offering materials Orrick assembled and distributed as bond counsel, and approved as disclosure counsel, in one place state that actuarial funding was legally required *and* in another place admit that actuarial funding was not occurring. Orrick either missed this discrepancy or knowingly condoned this nonsensical “disclosure.”

58. V&E’s report is silent on how Webber and Orrick, City disclosure counsel on *years* of City bond offerings, could not understand their own disclosure. Rather than observe and explore the obvious failure by Orrick, V&E adopted as true Orrick’s false denial of knowledge of the pension under funding before its September 2003 “discoveries.”

⁴³ Exhibit 34 (November 1, 2005, meeting minutes of the San Diego City Council).

1 59. V&E did this even though the evidence available to V&E showed undeniably that
2 Orrick *did* know well before September 2003 that the City was not complying with the “State
3 legislation” Orrick declared existed requiring actuarial funding of pensions.

4 60. For example, Orrick obtained the SDCERS pension system’s actuarial valuation
5 for 2001, wherein the actuary explicitly stated that the City was *not* funding SDCERS based on
6 actuarial rates:

7 Overall, the financial condition of the retirement system continues
8 to be in sound condition in accordance with actuarial principles of
9 level-cost financing. However, we want all parties to be acutely
10 aware that **the current practice of paying less than the
computed rate of contribution or pickup will help foster an
environment of additional declines in the funding ratios in
absence of healthy investment returns.**

11 This warning is the exact opposite from what *years* of Orrick prepared bond offerings declared
12 “State legislation” required.

13 61. Orrick not only possessed the 2001 valuation, by March 2002, it pursued City
14 Staff with certain questions about its contents.⁴⁴ Orrick originally posed questions to Lakshmi
15 Kommi of the City’s Financing Services Department. Webber admitted to V&E that “[h]e
16 obtained some projections related to the UAAL from Ms. Kommi.”⁴⁵ Mr. Webber also admitted
17 to V&E that he looked at the City’s pension disclosures **in 2002**.⁴⁶

18 62. One could not do both of the things Webber admitted to V&E that he did in
19 2002—review the UAAL projections and look at the City’s pension disclosures—and not see
20 everything Orrick denied to V&E (i.e., that it was directly aware of the massive under funding of
21 the System). What’s more, Webber admitted to V&E that he did and knew all of this **in 2002**
22 (18 months before Orrick claimed to V&E it had discovered the problem).

23 63. Again the next year, and before September 2003, Webber received the actuary’s
24 valuation, denominated the 2002 actuarial valuation (issued in January 2003). Webber admitted
25 to V&E that he possessed the 2002 Valuation Report by June or July 2003—six months before

26 _____
27 ⁴⁴ Exhibit 35 (March 18, 2002, email from Patrick Lane, subject FY2001 acturial [sic] valuation).

28 ⁴⁵ Exhibit 36 at DS0435860 (July 11, 2004 Memorandum from Tim J. Deithloff to Paul S. Maco).

⁴⁶ Exhibit 36 at DS0435860.

1 Ms. Shipione's e-mail.⁴⁷ This time, the valuation showed a UAAL of about \$700 million—
2 nearly triple the year before. And this time the actuary *declined* to describe SDCERS as
3 actuarially sound. Instead, it described the condition of SDCERS as “adequate”:

4 Overall, the financial condition of the retirement system *is in*
5 *adequate condition* in accordance with actuarial principles of level-
6 cost financing. However, all parties should be acutely aware that
7 the current practice of paying less than the computed rate of
8 contribution will help foster an environment of additional declines
9 in the funding ratios in the absence of healthy investment returns.
10 (Emphasis added.)⁴⁸

11 64. From this valuation, which Orrick admitted to V&E possessing at the time,⁴⁹
12 Orrick knew the pension under funding was material and required disclosure. Webber even
13 admitted to V&E that *he would have discovered the City's pension under funding to be material*
14 even if Diann Shipione had not come along:

15 Mr. Webber believed that even if Diann Shipione hadn't come
16 along, he would have discovered the City's pension situation (both
17 retirement benefits and post-retirement health care benefits) to be
18 material because, if one were to look at the prospective amounts
19 the City was paying in relation to their budget, there was no way
20 the City could make 100% of the required payments.⁵⁰

21 65. Webber also admitted to V&E that *he did not discuss what he knew to be material*
22 *information with the City:*

23 [T]he problem with it [the nondisclosure of the rising UAAL] is
24 that they didn't tell the market and didn't consider the
25 consequences (which is that they would eventually have to pay the
26 debt). **Mr. Webber did not recall talking to anyone at the City**
27 **about the aforementioned comments.** (Emphasis added.)⁵¹

28 ⁴⁷ Exhibit 36 at DS0435857.

⁴⁸ Exhibit 37 at p.17 (July 30, 2002 San Diego City Employees' Retirement System Annual Actuarial Valuation).

⁴⁹ Exhibit 36 at DS0435857.

⁵⁰ Exhibit 38 at DS0435877 (March 8, 2004, Memorandum from Benjamin S. Lippard to Paul S. Maco).

⁵¹ Exhibit 31 at DS0435877.

1 66. During that same year, and before Ms. Shipione’s September 2003 e-mail, Orrick
2 was tasked with analyzing and providing disclosure concerning the Gleason case. “Mr. Webber
3 [himself] prepared a draft of the Gleason case disclosure based on the work of Luce Forward.”⁵²

4 67. No one could review the Gleason case, much less provide legal disclosure to Wall
5 Street regarding its import, without becoming painfully aware of the City’s under funding of the
6 pension, which one of the pleadings in the case described as “The ‘China Syndrome’ of Pension
7 Debt.”

8 68. It does not appear that V&E ever asked, much less followed up on, the question of
9 why Orrick, possessing the knowledge it did, didn’t act sooner; *or* why it never previously did
10 anything to correct the obvious incongruities in the bond offerings; *or* why it claimed, falsely, to
11 be surprised by what it had supposedly learned for the first time in September 2003.

12 69. Perhaps the answer to these inquiries lies deep buried in V&E’s own Report,
13 where tucked away in footnote 350, is the following “disclosure”:

14 Mr. Maco, a Vinson & Elkins partner who is also an author of this
15 Report, had, prior to this time, provided Securities law advice to
16 the City on a matter unrelated to the matters at issue here. He was
17 asked by the City to also serve as a “sounding board” *as the City*
18 *prepared its pension disclosure* [which was made on January 27,
2004, *before* V&E began its investigation] and [was] **asked as to**
whether the expansive disclosure advocated by Mr. Webber
was appropriate. *He concurred with Mr. Webber’s judgment.*
(Emphasis added.)⁵³

19 70. Thus, from V&E’s own admission, *even before* it began its investigation, V&E
20 had already served as Webber’s “sounding board,” leaving little room to wonder where V&E
21 would end up after investigating Webber (and, by extension, *itself*).

22 **L. The SEC And U.S. Attorney Investigations Are Still Unresolved, And The**
23 **City Awaits What V&E Promised More Than Two Years Ago: An**
24 **“Objective ‘Warts And All’ Report”**

25 71. When the City terminated V&E in August 2005, and despite running up bills of
26 \$6.2 million, V&E had not delivered on its most material contractual promise to prepare an
27 “objective ‘warts and all’ report” of the City’s behavior.

28 ⁵² Exhibit 31 at DS0435876.

⁵³ Exhibit 13 at p. 118.

72. Meanwhile, the City now awaits Kroll's report (and final bill, the total of which is expected to exceed \$20 million), a retention (and payment) that would have been unnecessary had V&E done its job.

73. Meanwhile,

- a. the City still does not have audited financial statements 2003, 2004, and 2005;
- b. the SEC investigations and U.S. Attorney investigations are similarly unresolved; and,
- c. on January 6, 2006, the U.S. Attorney's Office announced its indictments of three former trustees of the SDCERS system: Ron Saathoff, president of the San Diego Firefighters Association Local 145; Cathy Lexin, former Human Resources Director for the City; and Terri Webster, former assistant auditor and comptroller for the City. The indictments also named former SDCERS Administrator Lawrence Grissom, and Lorraine Chapin, general counsel at SDCERS.⁵⁴

IV.

PARTIES

74. Plaintiff, City of San Diego, is a municipal entity established by charter pursuant to California Constitution Article XI section 3.

75. On information and belief, Defendant V&E is an entity of unknown qualification, which purports to be a professional limited liability company incorporated in the State of Texas or a limited liability partnership, which in either case has its principal place of business in Texas, located at 2300 First City Tower, 1001 Fannin Street, Houston, Texas.

76. Plaintiff is ignorant of the true names and capacities, whether individual, corporate, associate, or otherwise, of defendants Does 1 through 25, inclusive. Upon information and belief, each fictitious defendant is in some way responsible for, participated in, or

⁵⁴ Exhibit 39 (January 6, 2006. United States District Court Southern District of California January 2004 Grand Jury: United States of America, Plaintiff, v. Ronald Saathoff (1), Cathy Lexin (2), Teresa Webster (3), Lawrence Grissom (4), Lorraine Chapin (5), Defendants. Criminal Case No. 06CR0043BEN. Indictment: Title 18, U.S.C., Sec. 371 – Conspiracy to

1 contributed to, the matters and things of which Plaintiff complains herein, and in some fashion,
2 has legal responsibility therefore. When Plaintiff ascertains the exact identity of each such
3 fictitious defendant and the nature of such fictitious defendant's responsibility for, participation
4 in, and contribution to, the matters and things herein alleged, Plaintiff will seek to amend this
5 complaint to set forth the same.

6 77. Plaintiff is informed and believe and thereon alleges that each defendant named in
7 this action, including Doe defendants, at all relevant times, was the agent, ostensible agent,
8 servant, employee, representative, assistant, joint venturer, and/or co-conspirator of each of the
9 other defendants, and was at all times acting within the course and scope of his, her, or its
10 authority as agent, ostensible agent, servant, employee, representative, joint venturer, and/or
11 co-conspirator, and with the same authorization, consent, permission or ratification of each of the
12 other defendants.

13 **FIRST CAUSE OF ACTION**

14 **BREACH OF CONTRACT**

15 **(Against All Defendants)**

16 78. Plaintiff incorporates the allegations of Paragraphs 1-77, inclusive, of this
17 Complaint as though set forth here in full.

18 79. V&E and the City entered into at least two agreements (as reflected in Exhibits 6
19 and 19) (and as updated from time to time as reflected in Exhibits 10, 11, 18, 20, 23 and 24) to
20 provide the services herein complained of, viz., V&E's representation of the City in defense of
21 the SEC and U.S. Attorney investigations, including the preparation of the Report, and the
22 rendering of assistance to KPMG (the Agreements).

23 80. Expressly or impliedly, or both, the Agreements required V&E to comply with
24 professional standards of care.⁵⁵

25
26
27 Commit Wire and Mail Fraud; Title 18, U.S.C., §§ 1343 and 1346 – Wire Fraud; Title 18,
28 U.S.C., §§ 1341 and 1346 – Mail Fraud; Title 18, U.S.C., Sec. 2 – Aiding and Abetting).
⁵⁵ Benenato v. McDougall (1913) 166 Cal. 405, 408 (professional service agreement implies
performance in compliance with professional standards).

1 81. The Agreements expressly required V&E to perform an investigation with an
2 “initial scope” that “will be agreed upon by separate cover.” V&E never did that.

3 82. The Agreements expressly required V&E to prepare a Report that would “not be
4 an advocacy document,” but would, according to V&E, be an “objective ‘warts and all’ report.”
5 V&E never did that. (The Agreement reflected by Exhibit 19 (and amended by Exhibit 23)
6 required V&E to apply the same standard to its second report, which, again, V&E did not do.)

7 83. The Agreements expressly required V&E to perform work at a discount “in
8 recognition of the governmental nature of the client.” This promise implies that V&E would not
9 charge the City for unnecessary work, which V&E did, as alleged herein.

10 84. The Agreements state that “we anticipate that most of the work would be
11 performed by two V&E partners . . . with assistance of several associates as needed.” This
12 statement was simply false when it was made a second time (as reflected in Exhibit 19), as by
13 then (and as later would hold true), V&E had thrown a dozen or more associates at the file, who
14 were racking up hours at a pace of three to five times that being spent by the two partners. In
15 any event, in addition to being false, the statement implies that V&E would not charge the City
16 for unnecessary work by additional attorneys, which V&E did, as alleged herein.

17 85. V&E billed the City for unnecessary legal work, billing \$6.4 million in fees—the
18 equivalent of a well paid attorney working 8 hours a day, 5 days a week, 50 weeks a year *for ten*
19 *years*)⁵⁶—which itself was not only a breach of fiduciary duty (as alleged below), but was also
20 nearly \$1 million in excess of the approved contracts and amendments thereto, as alleged.

21 86. The City performed all covenants, conditions, terms, and promises required to be
22 performed by it by the Agreements, except for any obligations that were excused by V&E’s
23 conduct and refusal to perform.

24 87. V&E materially breached the Agreements by engaging in the acts alleged in this
25 Complaint.

26
27
28 ⁵⁶ A well paid attorney, earning \$300 per hour, would thereby generate fees of \$6 million.

1 88. V&E's material breaches directly and proximately caused damage and injury to
2 the City, in an amount presently unknown, but in excess of this court's jurisdictional minimum,
3 the extent of which will be proven at trial.

4 **SECOND CAUSE OF ACTION**

5 **BREACH OF FIDUCIARY DUTIES**

6 **(Against All Defendants)**

7 89. Plaintiff incorporates the allegations of Paragraphs 1-88, inclusive, of this
8 Complaint as though set forth here in full.

9 90. A lawyer, like V&E here, owes its client fiduciary duties of uncompromised
10 loyalty.

11 91. As the City's fiduciary, V&E was required to disclose all information material to
12 the City's interests; was required to put the City's interests above its own; and was required to
13 exercise the greatest diligence in protecting the City.

14 92. The fiduciary duty of loyalty required V&E to place the interests of the City, its
15 beneficiary, over any personal interest of the firm.

16 93. As set forth herein, V&E breached its fiduciary duty to the City by failing to
17 protect the City's interests, by, among other things:

- 18 a. inducing the City to retain it on the pretext that it would
19 complete the work in two months and for \$150,000 (when
20 V&E knew that it would charge the City substantially more
 and take substantially longer to complete the work it
 planned on doing);
- 21 b. inducing the City to retain it to perform an investigation,
22 when it had already formed specific opinions, and even
23 advised the City's Disclosure Counsel on recommended
 courses of action, before it began its investigation;
- 24 c. taking advantage of its own failure to prepare, and to
25 conform its investigation to, an "initial scope" that would
 define the investigation it was conduct;
- 26 d. charging the City for unnecessary legal work that was
27 performed only to generate fees for V&E, not for any
 benefit that it would confer on the City; and
- 28 e. by knowingly exceeding the City Council serial
 appropriations, made for V&E "to complete the report,"

1 when V&E knew full well that it had the City over a barrel
2 and could continue to bill the City for reports that V&E
3 knew or should have known would not be accepted by the
SEC or the U.S. Attorney or KPMG.

4 94. In doing the acts herein alleged, and others presently unknown to the City, V&E
5 did not exercise the care and corresponding degree of fairness and good faith and fair dealing
6 toward the City's interests as were required of it by virtue their fiduciary relationship.

7 95. V&E's material breaches directly and proximately caused damage and injury to
8 the City, in an amount presently unknown, but in excess of \$10 million, the extent of which will
9 be proven at trial.

10 96. V&E's misconduct in causing the injuries and damage to the City was intentional,
11 willful, malicious and oppressive. The City is entitled to an award of punitive and exemplary
12 damages against V&E in an amount to be established according to proof at the time of trial.

13 **THIRD CAUSE OF ACTION**

14 **PROFESSIONAL NEGLIGENCE**

15 **(Against All Defendants)**

16 97. Plaintiff incorporates paragraphs 1-96 as if fully alleged here.

17 98. At all relevant times, V&E owed the City a duty of care and skill in performing
18 professional services on behalf of the City. V&E also had an obligation to comply with
19 applicable professional standards, as promulgated from time to time.

20 99. V&E breached its duty to exercise reasonable care and skill in performing
21 accounting services as set forth above.

22 100. As a proximate and legal result of V&E's negligence, the City has been damaged
23 in an amount presently unknown, but in excess of \$10 million, the extent of which will be proven
24 at trial.

25 101. V&E continuously represented the City regarding the same subject matter, *viz.*,
26 V&E's representation of the City in defense of the SEC and U.S. Attorney investigations,
27 including the preparation of the Report, and the rendering of assistance to KPMG, until at least
28 August 2005.

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PRAYER FOR RELIEF

WHEREFORE, Plaintiff prays for judgment as follows:

- 1. For general damages according to proof;
- 2. For punitive damages on the second cause of action; and
- 3. For costs of suit incurred herein, and for such other and further relief as the Court deems just and proper.

Dated: July 27, 2006 STANFORD & ASSOCIATES

BRYAN C. VESS APC

By: _____
Bryan C. Vess
Attorneys for Plaintiff
CITY OF SAN DIEGO